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98TH CONGRESS
1st Session

SENATE

REPORT
No. 98-293

THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 2040

together with

ADDITIONAL VIEWS

NOVEMBER 2 (legislative day, OCTOBER 31), 1983.—Ordered to be printed

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NOVEMBER 2 (legislative day, OCTOBER 31), 1983.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 2040]

The Committee on Banking, Housing, and Urban Affairs reports favorably an original bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the treatment of mortgage-backed securities, to increase the authority of the Federal Home Loan Mortgage Corporation, and for other purposes, and recommends that the bill do pass.

HISTORY OF LEGISLATION

The Subcommittee on Housing and Urban Affairs has held a series of hearings on legislation and issues pertinent to the Committee approval of this bill.

The Committee began consideration of these issues two years ago and held initial oversight hearings on April 7, 1981 and April 14, 1982. A hearing on the outlook for housing and mortgage finance was held on February 14, 1983. Housing oversight hearings regarding the secondary mortgage market were held on March 8, 1983. On May 5, 1983, hearings were held on the proposed changes in the charter of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Hearings on the Secondary Mortgage Market Enhancement Act of 1983 and the Trust for Investment in Mortgages Act of 1983 were held on September 21 and 22, 1983. The full Committee met on October 6, 1983 and ordered the bill favorably reported by voice vote.

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For ease of writing, the Committee refers in the balance of this report to the market or common names of the Federal secondary mortgage market agencies. Thus, the Government National Mortgage Association is "Ginnie Mae," the Federal National Mortgage Association is "Fannie Mae" and the Federal Home Loan Mortgage Corporation is "Freddie Mac". Similarly the term "mortgage-backed securities" is abbreviated "MBS".

EXPLANATION OF THE LEGISLATION

As recently as ten to twenty years ago, the capacity to attract investor based capital to the mortgage market had not developed to any great degree. Moreover, as population shifts and homebuilding demand moved cross country to the west and southwest, the demand for mortgage capital and its sources became separated. The Federal government launched two agencies whose purpose it was to form the conduit that would encourage investors to place their money in securities backed by residential mortgages and thus supplement the development of mortgage capital from traditional portfolio lender sources. Fannie Mae and Freddie Mac have served well, and made mortgage-backed securities acceptable to investors by standardizing products and procedures and by developing a range of investment instruments.

It has become apparent to the Committee, through hearings and research over the past two years, that once again dramatic changes are occuring which will increase the demand for mortgage capital at the same time that the traditional sources of such capital are caught up in fundamental structural changes. Deregulation of the financial services industry and the memory of the experiences of the 1981–82 recession are combining to further erode the role of the portfolio lender of mortgage capital.

Due to the projected magnitude of the demand for mortgage credit, the existing Federal agencies simply will not be able to provide all of the liquidity for mortgages that will be required during the remainder of this century. For the consumer, this scarcity would mean that mortgages would cost more and be more cumbersome to obtain.

The clearly defined course of action for this Committee became, therefore, one of seeking to broaden the number of participants channeling investor capital to the homebuyer. If Fannie Mae and Freddie Mac have met the objectives for which they were originally created, then the foundation is in place for the private sector to assume a more significant market role.

Almost two years ago, an important procedural deregulation trend began, complementing the structural changes occurring in the financial services industry. For the first time, it became economically attractive for private sector actors to form conduit operations through which they could pass ownership in pools of mortgages to investors in the form of "pass-through" securities. For example, one of the more significant procedural improvements was the inception of delayed or continuous registration of mortgage-backed securities with the Securities and Exchange Commission. Under this procedure a single registration filed by a private conduit would enable that conduit to form new pools of mortgages and sell them as pass-through

securities to investors on a continuous basis so long as each successive securities offering and its underlying pool of mortgages represented a continuous sale of essentially the same security described in the original registration. This new procedure recognized the unique nature of this market because mortgages included in the pools backing the securities are originated after commitment for the purchase of the securities is made. Delayed or continuous registration avoids the added cost of individual registration of new offerings, without damaging investor protection. More importantly, it also avoids the delay inherent in the preparation and review of individual registrations. Large pools of mortgages are interest rate sensitive and must be sold into the market immediately upon their formation in order to lock in rates and pass off the rate risk before the market changes.

On October 6, 1983, the Committee culminated its efforts to broaden the secondary market by reporting a clean bill in lieu of S. 1821.

This bill is expressly designed to encourage this broadening of the market for mortgage-backed securities by encouraging more extensive involvement of the private sector in the formation of conduits for the flow of mortgage capital from investors to lenders and homebuyers. The bill accomplishes this goal in three ways. First, it continues the process of procedural deregulation which has already markedly improved the operation of the securities market generally. The bill focuses on removal of archaic regulation of mortgage-backed securities which prevent them from functioning in the market as well as other corporate securities, let alone securities sold by Fannie Mae and Freddie Mac.

Second, it seeks to broaden the classes of investors, especially institutional investors, who could purchase mortgage-backed securities but for artificial or archaic regulatory roadblocks.

Third, it changes Fannie Mae's and Freddie Mac's authority only in limited areas. The Committee recognizes the continuing and important role these two agencies will play especially to the market serving lower and middle income homebuyers. But we also believe that a portion of the public market for mortgage-backed securities, namely that for mortgages above $108,300 (jumbo loans as they are called), should be preserved for the private sector.

Fannie Mae and Freddie Mac, along with the Government National Mortgage Association which functions in the FHA and VA insured mortgage market exclusively, together account for 87–92 percent of all public secondary mortgage activity.

These agencies, with their distinct market advantages which can be attributed to their government backing, present insurmountable economic competition to the embryonic private sector. This bill reported by the Committee, and S. 1822, the so-called Trust-for-Investments in Mortgage Securities bill, are together designed to eventually enhance head-to-head competition with the governmental agencies. However, the Committee believes that in order to provide the proper environment for the private sector to develop an immediate presence in the market, we must isolate a portion of the market where such imbalanced competition will not occur.

In declining to consider changes to current dollar limits on mortgages that the governmental agencies can purchase, the Committee be-

lieves it accomplishes that objective. The Committee received no evidence that mortgage credit was not available at amounts above $108,300 (the current limit on Fannie Mae and Freddie Mac which is adjusted automatically each year in any case, by changes in the average cost of housing). During the 1981–82 recession, most of the new purchase activity which occurred was in the "upper brackets" or jumbo mortgage area. Mortgages above $108,300 do cost more, but frequently not significantly more than those below the limit. This legislation is expected to close that differential even further.

Moreover, mortgages above $108,300 require qualifying incomes of at least $50,000. The federal agencies, which enjoy a preferential economic status in the market because of their governmental linkage, were created to primarily assist lower and middle income homebuyers obtain credit. The Committee believes these agencies should continue to direct their service toward its present clientele especially when the private sector can serve needs of higher income families.

During discussions of the role of the private sector, the question frequently arose, "won't private conduits be fairweather friends dropping out of the market if the economy turns down?" The Committee believes this not to be the case since the private sector will find profitable opportunities even in a down cycle. As an example, Freddie Mac which had the best business year of its history in 1982, did so through the issuance of conduit mortgage securities on which there is little interest rate risk or financial exposure. This business is governed by the "spread" between the conduits cost of funds and the yield on the mortgages that comprise the pool. Therefore, a conduit business can still be successful even though interest rates are rising. Credit is available to homebuyers albeit as recent experience demonstrated, its cost may be beyond the reach of many Americans. While the Committee obviously wants no return to the housing recession of 1981–82, this bill, along with S. 1822, hopefully will remove most of the artificial cost of mortgage capital attributable to regulatory limitations on the operation of the market which no longer fit todays market environment. Attaining this goal will directly benefit the consumer/homebuyer by reducing mortgage costs.

While witnesses who appeared before the Committee differed with respect to the extent of the downward impact this bill would have in interest rates, virtually all the witnesses responding to the question felt the impact would be favorable. There is virtually no disagreement that the enactment of S. 1822 along with this bill would have a dramatic downward affect on mortgage rates.

SECTION-BY-SECTION ANALYSIS

The title of the bill is: "The Secondary Mortgage Market Enhancement Act of 1983."

Title I

Title I contains a number of banking and securities act amendments that will remove technical impediments to trading and investing in private mortgage-backed securities. Many of these impediments exist because mortgage-backed securities were unknown when most of the securities laws and statutes governing investments by financial institu-

tions were enacted. Similarly, State restrictions concerning legal investments for various State-chartered or regulated institutions, pension funds, and trust managers have generally not reflected the existence of mortgage-backed securities when they were enacted. Thus, amendments in this title will allow market flexibility in mortgage security transactions and expand the potential base of investors for such securities. This should substantially enhance the ability of private issuers of mortgage-backed securities to provide liquidity to mortgage lenders and reduce the cost of mortgage credit for homebuyers.

Transactional registration exemptions.—Section 101 rewrites Section 4(5) of the Securities Act of 1933 to update and broaden the applicability of the current transactional exemption from security registration requirements applicable to large transactions in mortgage-backed securities issued by financial institutions and sold to sophisticated institutional investors.

Section 4(5), originally enacted in 1975, was an initial legislative attempt to encourage the issuance of private mortgage-backed securities. Section 4(5) is designed to expedite the sale by mortgage originators (essentially financial institutions supervised by either state or Federal agencies) of securities backed by pools of mortgages to sophisticated institutional investors buying for their own account. If the sale involves minimum transactions of at least $250,000, the transaction is not required to be registered under the 1933 Securities Act. Such transactions do not require all of the normal investor protections provided by the 1933 Act. Institutional investors, because of the sheer size and economic impact of their securities purchases, generally can force the market to disclose information essential to assuring the safety, soundness and economic benefit of their transactions. Section 4(5) therefore removes the burden and cost of registration of securities involved only in the transactions described above. It should be noted, however, that any resales of such securities must be made pursuant to another exemption from registration, such as that provided by section 4(1) of the Securities Act in order to avoid the necessity for registration of the resale transaction;

In reexamining section 4(5) in light of present day market conditions, the Committee determined that several "updating" changes were indicated.

First, the current exemption only applies to securities backed by traditional first mortgages on residential or commercial real estate. The rewrite also applies the Section to securities backed by second mortgages, cooperative housing loans, and manufactured home loans.

Second, recognizing that mortgage-backed securities now come in many forms beyond those backed by whole loans, the types of securities which may be granted a transactional exemption under this provision are broadened to include mortgage-backed payment securities. Such new instruments may differ from the traditional form in significant ways. For example, the securities may not provide the investor direct recourse to an underlying mortgage, or it may be a security collateralized by pools of other mortgage-backed securities such as those issued by the Government National Mortgage Association. To the extent that such new instruments may raise investor protection questions, the Committee has required that such securities to be eli-

gible for the 4(5) exemption, must be rated as investment grade securities in one of the top four rating categories used by a nationally recognized statistical rating agency.

Third, the exemption is made available to securities originated by any HUD-approved mortgage (principally mortgage bankers) in addition to financial institutions. Currently such issuers may only sell securities under the transaction exemption to depository institutions.

Fourth, the minimum transaction amount of $250,000 is intended by the Committee to apply only to the initial purchase amount rather than the current interpretation which requires a considerably larger initial sale threshold.

Fifth, the 60-day limit for cash payment on settlement of the delivery of the security is extended to 120 days recognizing the typically longer lead time required to actually assemble the mortgages in the pool underlying the security.

Investment by depository institutions.—Section 102 liberalizes existing statutory restrictions imposed on federally chartered financial institutions affecting their ability to invest in mortgage-backed securities. Such restrictions would be lifted save for limitations imposed by their respective federal regulators.

Specifically, this section amends the Home Owners Loan Act to permit thrift institutions to invest in mortgage-backed securities described in Section 101 subject only to conditions imposed by the Federal Home Loan Bank Board. Likewise, the Federal Credit Union Act is amended to allow federal credit unions to invest in mortgage-backed securities for the first time, again as regulated by the National Credit Union Administration.

With respect to national banks, under existing law national banks may not generally invest more than 15 percent of unimpaired capital stock and surplus in the investment securities of any one issuer. Housing revenue bonds issued by municipalities and states and obligations of the Federal housing agencies—Ginnie Mae, Fannie Mae and Freddie Mac—are exempted from this limitation under current law. Section 103(c) extends this exemption to private MBS, described in Section 101, subject to conditions imposed by the Comptroller of the Currency.

The clear intent of the Committee with this section is to permit supervised financial institutions to become more active investors in private MBS. The Committee believes that the safety and soundness of depository institutions is not jeopardized by the additional investment authority conveyed by this section. Mortgage backed securities are not inherently risky investments. They are backed by a pool of many mortgages with relatively low default risk as well as mortgage insurance on both the individual mortgages and the pool. Moreover, as is the case under existing law, institutions are subject to the continuous scrutiny of their regulators who require prudence and good business judgment in the management of investment accounts and who normally insist that institutions invest in no less than investment grade securities.

Preemption of legal investment laws and State blue sky laws.—Section 103 preempts State legal investment laws and regulations so that investment grade mortgage-backed securities may be liberally purchased by State-chartered and regulated financial institutions, insur-

ance companies, pension funds, trustees or other regulated entities as if they were Federal agency securities.

Many current State laws establishing legal investment criteria were written when mortgage-backed securities were generally unknown. In consequence, these securities are adversely affected by limitations which artificially limit demand without regard to the soundness of the investment itself. The bill also preempts State blue sky laws which require registration of securities with appropriate state supervisory agencies. Such registration requirements are duplicative of requirements of the Federal securities law and impose additional fees on the total cost of marketing the Security. This provision therefore removes such duplicative procedures from the marketing system. This provision does not overturn state anti-fraud statutes or other state requirements imposed on the operations of dealers and underwriters of such securities. States may also reassert limitations on investment in or registration requirements for mortgage securities if they find them necessary within 3 years from enactment of this bill. This preemption section also applies to mortgage-backed securities issued by Fannie Mae or Freddie Mac.

It should be understood, however, that in requiring that private MBS be treated in the same manner under State legal investment and blue sky laws as securities issued by the United States, we do not intend that the comparison extend beyond just that. Certainly, the Committee does not intend and the language should not be construed to create any warrant or moral obligation on the part of the United States government on behalf of any such private security exempted from State requirements.

Under Section 103 mortgage-backed securities which are described in Section 4(5) of the Securities Act of 1933 and which are rated in the investment grade categories will be treated similarly to obligations issued or guaranteed by the United States. Thus, if state law limits the purchase, holding, or investment in Government obligations, these mortgage-backed securities will be considered to be obligations issued by the United States for purposes of that limitation.

As an example, many states have statutory restrictions designed to limit the amount of any insurer's assets and/or surplus to be invested in any single security or in any particular class or type of investment. The purpose of these restrictions is to prohibit any concentration of an insurer's assets in its investment portfolio which would be to the potential detriment of its policyholders. This Act will neither preempt nor expand these state statutory percentage restrictions. Thus, if state laws allows no more than 25 percent of assets to be invested in U.S. government obligations, then under this act, the combined total of all US. obligations and investment grade mortgage-backed securities would be limited to 25 percent of assets.

Delayed or continuous registration of private MBS.—Section 104 requires the Securities and Exchange Commission to provide a permanent procedure for the delayed or continuous registration of mortgage-backed securities pursuant to section 6 of the Securities Act of 1933. Delayed or continuous registration of MBS is currently provided for by an administrative guideline of the Commission. Evidence accumulated by the Banking Committee strongly suggests that such a proce-

dure is vital to the mechanics of the market for MBS and contributes significantly to reductions in the cost of issuance of such securities—savings which can be passed on directly to the homebuyer. Section 104 removes any uncertainty over the future of this procedure.

Nothing in Section 104 should be construed however, as an attempt by the Committee to influence or prejudice the Securities and Exchange Commissions deliberations and decision on the extension of its Rule 415 (related to shelf registration of corporate securities) or the broader issue of its choice among alternative methods of shelf registration of securities other than for mortgage-backed securities aided by this bill.

Net capital requirements.—A section of S. 1821 as introduced required equal treatment for purposes of net capital requirements of government agency-issued and privately issued investment grade mortgage-backed securities of comparable maturity. The bill as reported, however, does not include the provision addressing net capital requirements because of concerns expressed by the Securities and Exchange Commission. Those concerns focused primarily on the inability of the SEC, if operating under a strict statutory standard, to establish appropriate margin requirements for particular securities in response to fluctuating market conditions. Although the removal of the statutory requirement is designed to provide greater flexibility to the SEC, a continuing objective of this bill is to create an environment in which privately issued securities can be carried in the inventory of broker-dealers without an adverse effect on the required net capital. The Committee still adheres to that objective but has shifted the method of creating that environment from an inflexible statutory standard to the discretion of the SEC.

Margin requirements.—Another section of S. 1821 as introduced would have permitted broker-dealers to extend credit in connection with the initial sale of securities exempt from registration under revised Section 4(5) of the 1933 Act. However, it was decided to drop this section temporarily, to allow time to sharpen the focus of the language and to work out some of the technical details with the staffs of the Federal Reserve Board and the Securities and Exchange Commission. Some adjustment to the margin requirements is important to achieve the bill's objective of encouraging increased participation of the private sector in the secondary mortgage market. It is necessary because of the unique nature of the secondary mortgage market. Unlike issues of corporate debt securities, which customarily are issued for one-week settlement, the operation of the secondary mortgage is essentially a forward trading and delivery market that requires a settlement period of as much as four-to-six months. The extended period is required because the mortgages to be included in the pool backing the securities are originated only after commitments for the purchase of the securities have been obtained. Because most of the rules regarding settlement periods, extensions of credit, and broker-dealer relationships with their customers and with each other have been promulgated with a view toward the corporate debt securities market, adjustments to the applicable laws and regulations are necessary to accommodate the needs of private issuers of mortgage-backed securities. It should be noted that government-backed mortgage-backed securities are exempt from these rules now.

The Committee has been working with both the SEC and the Federal Reserve, and we plan to offer an amendment along these lines when the bill is considered in the Senate. We believe that the public policy goals of this legislation cannot be accomplished without a statutory provision addressing this issue.

Depository underwriting institution.—Another section in the legislation, as introduced, empowering depository institutions to also underwrite and deal in mortgage-backed securities was removed. The deletion of these powers was in deference to both the Administration, and the SEC, who would prefer to see the issuance of mortgage-backed securities considered in the same manner as other forms of securities underwriting as proposed in the Financial Institution Deregulation Act. The Committee, while taking this action, recognizes the increase in volume and market liquidity that would result by having bank participation. National banks for example, are currently intimately involved in mortgage finance including mortgage revenue bonds and the federal mortgage market agencies.

The question has arisen as to what relationship, if any, the Committee reported bill has to the Investment Company Act of 1940. The Committee decided that amendment of the Investment Company Act (15 U.S.C. 80a–1—80a–64) was not required in this bill to facilitate development of the private secondary mortgage market. A proposed amendment would have excluded from the definition of the term "investment company," and thus from the Act's coverage, certain companies investing in securities related to real estate where the company does not have the right of foreclosure. The Committee decided against including such an amendment, however, because it believes the Act currently (1) facilitates development of the private secondary mortgage market adequately and (2) contains important protections for investors in entities coming within the definition of the term "investment company" that should not be removed by statute in this instance.

The Investment Company Act currently exempts from its coverage companies primarily engaged in investing and dealing in mortgages. Specifically, Section 3(c)(5)(C) of the Act (15 U.S.C. 80a–3(c)(5)(C)) contains an exclusion from the definition of the term "investment company" for companies not issuing redeemable securities that are primarily engaged in acquiring mortgages and other liens on the interests in real estate. Thus, the Investment Company Act will not apply to most issuers of mortgage-backed securities.

The Committee expects that the Securities and Exchange Commission will monitor the private secondary mortgage market and provide appropriate administrative relief from the provisions of the Investment Company Act if compliance with the Act unnecessarily hinder development of the market. Section 6(c) of the Act (15 U.S.C. 80a–6(c)) empowers the Commission to grant exemptions from any provisions of the Act to the extent necessary or appropriate in the public interest and consistent with the protection of investors. The Committee believes that this authority will permit the Commission to deal with any problems that arise under the Investment Company Act in the area of mortgage-backed securities in a manner that assures adequate investor protection, and expects that the Commission will exercise this authority with a view to encouraging a vigorous private secondary mortgage market. The Committee always retains the option to

revisit the issue if future experience or other legislative action, such as exactment of S. 1822, warrant.

Title II contains two categories of changes to the charter acts of Fannie Mae and Freddie Mac. Primarily, these amendments are related to the existing authority granted to these agencies and have the effect of setting specific parameters for or clarifying this authority. They would commonly be known as housekeeping changes. The second type of amendments provide new authority to Fannie Mae and Freddie Mac. The Committee feels that these expansions of power are consistent with the traditional role of both agencies as they are limited within the housing sector and develop new secondary markets which will not produce competition with the private firms which are entering the market.

FHLMC and FNMA preferred stock.—Section 201 and 202 are follow-on provisions to authority granted in earlier legislation permitting Fannie Mae and Freddie Mac to issue preferred stock. The earlier legislation failed to prescribe any standards or conditions for issuance of such stock.

This section requires that preferred stock issued by Fannie Mae or Freddie Mac, other than preferred stock sold by Freddie Mac to the Federal Home Loan Banks, include terms that would be required to enable the preferred stock to be listed on the New York Stock Exchange. The New York Stock Exchange listing standards for preferred stock provide that exemptions to its voting rights requirements may not be granted when an issuing company cannot include such rights under the law of the jurisdiction of its incorporation. For example, these listing standards generally require that preferred shareholders have the right to elect at least two directors upon default of the equivalent of six quarterly dividends, but allow for listing of preferred stock without voting rights where the laws of the issuer's state of incorporation preclude such rights. Similarly, the New York Stock Exchange listing standards generally require a vote of at least two-thirds of the shares of outstanding preferred stock before the company can make any amendment to its corporate charter that would materially affect the existing terms of preferred stock. The amendments in Section 201 do not and are not intended to authorize Freddie Mac to grant preferred shareholders the right either to elect directors or approve changes to Freddie Mac's corporate charter. In the event the New York Stock Exchange does not waive its requirements with respect to this provision, Freddie Mac is not authorized to provide such voting rights in order to obtain a New York Stock Exchange listing.

Preferred stock sold by Freddie Mac exclusively to any Federal Home Loan Bank or Banks will not be required to meet otherwise applicable New York Stock Exchange listing requirements and can be sold upon whatever terms and conditions Freddie Mac's Board of Directors chooses to include. Such preferred stock, for example, could contain transfer restrictions precluding ownership of the stock by other than a Federal Home Loan Bank.

Limitations on participation agreements.—Section 203 clarifies statutory limitations governing the maximum principal obligation of mortgages purchased by Fannie Mae and Freddie Mac. The limita-

tions shall apply to the whole mortgage including the original face amount of the mortgage, not just its paid down balance, whether Fannie Mae or Freddie Mac purchases the entire loan or a participation interest in the loan. This provision is designed to assure that neither corporation purchases mortgages in the luxury market.

Manufactured housing loans.—Section 204 allows Freddie Mac to purchase loans on a manufactured home used as the principal residence of the borrower even when the home is considered personal property or mixed personal and real property. FNMA already has this authority under its charter Act. Currently Freddie Mac may only purchase loans secured by manufactured homes that are considered real property under State law. The Committee expects Freddie Mac to implement this program promptly to finance manufactured homes which can help provide lower—income home buyers a lower cost housing opportunity, while recognizing the different risks and procedures for claim settlement that may apply to personal property loans.

State agency insured mortgages.—Section 205 provides a technical clarification of the definition of "conventional mortgage" in the Freddie Mac charter act so that mortgages insured by a state agency may be treated just like mortgages insured by a private mortgage insurer. This amendment will allow Freddie Mac to purchase loans insured by any of the five state housing insurance programs now run by California, Maryland, New York, Puerto Rico and Vermont, and others as they develop. While the number of states with those programs is limited now, this trend may increase in the future.

Guarantee of mortgages backed securities issued by others.—Section 206 is a technical amendment to the Freddie Mac charter act to clarify that Freddie Mac may not guarantee mortgage securities backed by mortgages which Freddie Mac has not purchased. The Committee believes that Freddie Mac's current procedure of purchasing mortgages for subsequent resale as a guaranteed pass-through certificate or for backing other forms of securities is working well. The references to the guarantee of mortgage-backed securities or mortgage-backed payment securities does not imply that the Corporation has authority to issue securities backed by financial resources of other the entities which are not mortgages. Thus, the clear intent of the Committee is to allow a continuation of its existing mortgage security procedures while prohibiting Freddie Mac from using its guarantee authorty for mortgages or other financial instruments not purchased by it.

Limit on HUD approval.—Section 207 is intended to strike a balance between the need of Fannie Mae to respond to new housing finance needs on a timely basis and the need of the Secretary to undertake an appropriate review of the Fannie Mae request. The 45 calendar day period, with a 15 day extension if necessary, provides sufficient time for HUD staff and Secretarial review at least in those instances where all information necessary for Secretarial decision is obtainable from Fannie Mae or is otherwise within HUD's possession. The Committee recognizes that in some instances the Secretary's decision on Fannie Mae requests may require consideration of factors external to both Fannie Mae and HUD, such as the competitive impact of a proposed Fannie Mae undertaking upon private sector participants in

the secondary markets, which can be fairly assessed only after obtaining and evaluating additional information from outside sources. This provision is not intended to inhibit the Secretary from seeking such relevant information from additional sources. The provision would require that where the Secretary has not decided to approve Fannie Mae request within the prescribed period because of such factors, those reasons be stated in the Secretary's report to Congress with a definite schedule for completion of the Secretary's review as soon as practical. When the Secretary reports disapproval of a Fannie Mae request, the report must disclose the Secretary's reasons for the disapproval. In the event the Secretary fails to act on FNMA request, or report to Congress on the reasons for disapproval within the prescribed time limit, FNMA may proceed as if the request were approved.

Multifamily loan-to-value ratio.—Section 208 removes current limits on the ability of Fannie Mae and Freddie Mac to purchase multifamily residential mortgages whose loan-to-value ratio exceeds 80 percent. The Committee takes this step, especially to assist lower to middle income multifamily project development because private mortgage insurance is generally not available. Removing the current loan-to-value restriction obviates the need for private insurance and thus permits the larger mortgage often required to make such a project viable. However, the Committee observes that such mortgages carry a proportionately higher level of risk, especially as the loan-to-value ratio approaches the 100 percent level. The Committee expects Fannie Mae and Freddie Mac to exercise considerable care in establishing appropriate underwriting standards and other protections such as additional loss reserves to avoid unusual losses to either Corporation.

Board of directors.—Section 209 expands Fannie Mae's Board of Directors to eighteen persons from the current fifteen. Each of the three new Board members would be stockholder selected breaking the current pattern of one Presidentially appointed member for every two elected by the stockholders. Fannie Mae requested expansion of its Board in response to growing Board responsibilities and workloads.

HUD annual report.—Section 210 requires an annual report from the HUD Secretary regarding the activities of Fannie Mae. This provision replaces an existing requirement, enacted in 1977, that the Secretary deliver a one-time report to Congress on the financial operations of Fannie Mae and the extent to which the activities of Fannie Mae meet the purposes of the Charter Act. That report, due to be transmitted to Congress by June 30, 1978, was never completed. In view of the high degree of widespread concern over the financial stability of Fannie Mae which existed during the period of extraordinarily high interest rates in 1981 and early 1982, the Committee requests the Secretary to complete and deliver to Congress, at the earliest practicable date, the review of the financial operations of Fannie Mae required by current law. Such a review should focus in particular on means by which a recurrence of the causes for concern which existed in 1981 may be avoided during any future period of similar economic conditions. The prescribed scope of the review and study required by current law should also serve as a basis for the scope of the recurring annual reports required by the amendment which should also include any other issues, analysis, or recommendations regarding Fannie Mae as the Secretary may have.

It should be noted in connection with the concern expressed about Fannie Mae's financial condition that the Committee wishes to comment on Fannie Mae's apparent business strategy. We concur in management's stated objective to shorten the maturity of its assets and lengthen the maturity of its liabilities as a part of its portfolio restructuring program. However, to the extent that this strategy involves the purchase of long term, fixed rate mortgages such a strategy will substantially increase the size of Fannie Mae's portfolio and thus its continued vulnerability to interest rate swings. We believe these mortgages should be securitized in a manner similar to the operations of Freddie Mac and thus avoid the interest rate risk. We especially wish to point out that Congress has not required Fannie Mae to make such purchases for its own portfolio. Its responsibility to provide market support in a down cycle economy, can be fulfilled by conduit operations.

Multifamily mortgage limits.—Section 211 permits revision of dollar limits on the face amount of multifamily residential mortgages which may be purchased by Fannie Mae and Freddie Mac. The provision allows increases in current limits in a manner parallel to and in concert with the method by which the Secretary of Housing and Urban Development makes similar adjustments to reflect higher costs of development in so called high cost geographic areas under the FHA multifamily insurance program authorized by Section 207(c) of the National Housing Act. In no case could an increase in the mortgage purchase limit for an area exceed 240 percent of the general insurance limitations imposed by Section 207(c) of the National Housing Act.

This provision is related to Section 208 of this bill. The Committee re-emphasizes its concern with the additional risk this new activity poses, but believes that the growing difficulty experienced throughout the country in making lower to moderate income multifamily apartment development economically feasible argues in behalf of providing the additional secondary market support available through sections 208 and 211.

Purchase of second mortgages by FNMA and FHLMC

Section 212 of the bill grants specific statutory authority to both Fannie Mae and Freddie Mac to purchase subordinate mortgage loans that are used either to purchase a home or to refinance the unpaid principal balance of a loan that was used to purchase the home. The Committee considers this amendment to be consistent with the established mission of both Fannie Mae and Freddie Mac to foster a nationwide system of home finance.

Second mortgages are becoming an increasingly important source of financing for homeownership. Many families are able to afford to purchase a home because it has an assumable first mortgage, but they often need a new second mortgage to complete the financing. The availability of affordable second mortgage funds makes it possible for others to sell their current homes so that they can buy new ones. In some areas of the country, large volumes of "creative financing" loans were originated during the recent period of high interest rates and will soon come due creating an urgent need for second mortgages. Since lenders are reluctant to originate loans that they cannot easily sell, the Committee bill would help ensure that there is an adequate

nationwide secondary market for subordinate loans that are used for the specific purposes of purchasing or refinancing homes.

Fannie Mae and Freddie Mac could purchase or otherwise deal in a second mortgage if it is secured by a one-to-four family residence that is the principal residence of the borrower. The total principal of the loans could not exceed $50,000 in the case of a single family home or $60,000 in the case of a two-to-four family home. Neither corporation could purchase a second mortgage under this authority if the total of that new mortgage plus the original principal amount of other outstanding loans on the residence that the corporation dealt in would add to a total that exceeds the corporation's dollar limitaton on first mortgage. The amount of the second mortgage also could not cause the outstanding indebtedness on the property to exceed 80 percent of the property's value unless the excess amount is insured, or the seller retains a participation of at least 10 percent, or the seller agrees to repurchase or replace the mortgage in the event of a default.

The authority provided in this section expires on October 1, 1985, by which time Congress would have the opportunity to evaluate the need for any legislative changes. Although Fannie Mae would be given this authority without the need for further action by the Secretary of Housing and Urban Development, the Committee notes that the Secretary will regularly report to the Congress on activity performed by Fannie Mae under this authority and any other authorities.

Section 212 of the bill provides Fannie Mae and Freddie Mac with similar authority, through October 1, 1985, to purchase and otherwise deal in second mortgages that finance homeownership and meet other specified criteria.

Section 212(a) amends Section 302(b) of the National Housing Act (the Fannie Mae Charter Act) by establishing specific authority to purchase, service, sell and lend on the security of, and otherwise deal in second mortgages on one-to-four family homes. To be eligible, a loan must be secured by the principal residence of the borrower and the proceeds must be used only to purchase the residence or repay the remaining balance of a loan that was used to purchase the residence. Authority to make commitments to purchase such loans expires on October 1, 1985. This amendment does not limit or otherwise affect Fannie Mae's preexisting authority to deal in home improvement or energy conservation loans granted in paragraphs 302(b) of the Fannie Mae Charter Act.

Fannie Mae would be permitted to deal in a second loan under this new authority only if it meets the following size criteria.

First, such a loan shall not exceed an amount equal to the dollar limitations established under Section 302(b)(2) minus the original amounts of all other outstanding mortgage on the property that Fannie Mae has purchased, serviced, sold, or otherwise dealt in. An outstanding mortgage is any mortgage the principal balance of which is not fully paid at the time the limitation applies.

Second, the loan shall not exceed dollar limitations established by the corporation. These limitations could not exceed $50,000 in the case of a single family residence or $60,000 in the case of a two- to four-family residence. These limitations apply to the original principal amount of the subordinate lien even if Fannie Mae purchases only participation interest in the lien.

Third, the second loans shall not exceed an amount that would cause the total outstanding indebtedness secured by the residence to exceed 80 percent of the property's value unless (i) that portion of the indebtedness in excess of 80 percent is insured by a qualified mortgage insurer (and not the corporation itself); or (ii) the seller of the mortgage retains at least a 10 percent participation interest in the mortgage; or (iii) the seller agrees, under conditions set by Fannie Mae, to repurchase or replace the subordinate mortgage on demand if the mortgage goes into default.

Section 212(b) provides comparable authority for Freddie Mac. Subsection (b)(1) expands the definition of "residential mortgage" contained in Section 302(h) of the Federal Home Loan Mortgage Corporation Act to include a subordinate loan that (i) is secured to a one- to four-family residence which is the principal residence of a borrower and (ii) is used only to purchase the residence or repay the remaining balance of a loan that was used to purchase the residence. This expanded purchase authority will expire on October 1, 1985. This section also deletes now obsolete language dealing with principal amount limitations on subordinate liens the proceeds of which are used for property improvements.

Section 212(b)(2) of the bill amends Section 305(a) of the Freddie Mac enabling legislation by adding a new subsection (4) that requires Freddie Mac to establish limitations on the maximum original principal amount for subordinate loans used to purchase or refinance which Freddie Mac may deal in under this new authority. These limitations could not exceed $50,000 in the case of a single family residence or $60,000 in the case of a two- to four-family residence. These limitations apply to the original principal amount of a subordinate loan even if Freddie Mac purchases only a participation interest in the loan.

Freddie Mac would be prohibited from purchasing or otherwise dealing in a purchase or refinancing subordinate loan if it exceeds an amount equal to the dollar limitations established in Section 305(a)(2) minus the original principal amounts of all other outstanding mortgages on the property that Freddie Mac has purchased, serviced, sold, or otherwise dealt in. This amendment does not limit or otherwise affect authority granted to Freddie Mac under other sections of the Federal Home Loan Mortgage Corporation Act, including authority to purchase, service, sell, or otherwise deal in second mortgages for home improvement or energy conservation.

Freddie Mac would be permitted to deal in a purchase or refinancing subordinate loan only if such loan would not cause the total outstanding indebtedness secured by a residence to exceed 80 percent of the property's value unless (i) that portion of the indebtedness in excess of 80 percent is insured by a qualified mortgage insurer (and not the Corporation itself), or (ii) the seller of the mortgage retains at least a 10 percent participation interest in the mortgage, or (ii) the seller agrees, under conditions set by Freddie Mac, to repurchase or replace the subordinate mortgage on demand if the mortgage goes into default.

REGULATORY IMPACT STATEMENT

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement

regarding the regulatory impact of the bill. This bill represents a significant deregulation of banking and securities laws related to the packaging of private mortgage backed securities.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirements of subsection 4 rule XXIX of the Standing Rules of the Senate in order to expedite the business of the Senate.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., November 1, 1983.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has reviewed S. 2040, the Secondary Mortgage Market Enhancement Act of 1983, as ordered reported by the Senate Committee on Banking, Housing and Urban Affairs, October 6, 1983.

Title I of S. 2040 would make a number of changes in federal securities laws, including codifying registration rules for certain trusts and investments, as well as broadening the scope of registration exemptions to include additional types of mortgages. It would facilitate the issuance of private, mortgage-backed securities by eliminating certain regulatory requirements. Section 103 would also preempt various state laws, allowing these securities to qualify as a permissible investment by certain groups, including banks and insurance companies.

It is expected that enactment of S. 2040 would increase the efficiency and flexibility of the private, secondary mortgage market, probably resulting in an increase in the number of private security offerings. To the extent that additional registrations would result, registration fees imposed by the Securities and Exchange Commission (SEC) would also increase. Because the future activity level of the total housing market is uncertain, as well as the extent to which private companies would generate additional offerings, it is not possible to estimate precisely the additional receipts to the federal government as a result of these provisions. For each billion dollars in additional private offerings, fees of approximately $200,000 would be paid to the SEC. According to testimony by representatives of the securities industry before the Senate Committee on Banking, Housing and Urban Affairs, new offerings in the range of $10 billion annually within the next several years could result from this legislation. If this occurs, additional fees of $2 million annually would be deposited into the general fund of the Treasury and would be reflected as revenues in the federal budget.

Title II of the bill would amend certain sections of the National Housing Act and the Federal Home Loan Mortgage Corporation Act. These acts authorize mortgage purchases and other activities of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Both the FNMA and

the FHLMC are federally sponsored corporations, and their activities are not reflected in the federal budget. The proposed amendments would mainly affect existing activities. New authority would, however, be provided that would allow the FHLMC to purchase loans, the security for which are subordinate liens. These amendments are expected to have no impact on the federal budget.

Title II would also require the Department of Housing and Urban Development (which regulates FNMA) to submit annually a report to the Congress on FNMA activity. It is expected that the Department would require no additional resources to prepare this report and that it would not add significantly to the federal budget.

Enactment of this bill would not affect the budgets of State and local governments.

Should the Committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

RUDOLPH G. PENNER,
Director.

ADDITIONAL VIEWS OF SENATORS RIEGLE, CRANSTON, SARBANES, DODD, DIXON, SASSER AND LAUTENBERG

We believe the Committee's bill is a modest but valuable step to help ensure that an adequate supply of funds is provided for home mortgages while the country's housing finance industry is undergoing historic changes.

In our judgment, the bill, as reported by the Committee, satisfies four important criteria that we have applied during consideration of the legislation.

First, it would encourage private firms to enter the secondary mortgage market as issuers of mortgage-backed securities. We strongly support that objective. In the years ahead, an expanded and assured flow of funds must be attracted into mortgage lending from non-traditional sources. Leading housing analysts suggest that mortgage-backed securities will have to supply over 75% of all housing credit by 1990. Since American homebuyers will benefit by having the secondary mortgage market as broad and deep as possible, Congress should do what is necessary to increase the number of firms in the market.

Second, the bill would maintain the ability of Ginny Mae, Fannie Mae, and Freedie Mac to provide funds for home mortgages and to respond to changes in the market. These organizations form the foundation of our country's housing finance system. Witnesses from all sectors of the housing industry testified that these three institutions are making vital and innovative contributions to the nation's housing in a very difficult time. We believe that any efforts to weaken these basic housing institutions would be irresponsible, particularly now that the demand for housing has finally begun to rebound from disastrously low levels.

Expert witnesses agreed that private companies would be unable to issue mortgage-related securities in the volume needed to produce an active and sufficient secondary market for at least another five to ten years. We believe therefore that, in the meantime, we must be sure that the existing mortgage system remains vigorous.

We are encouraged by testimony which indicated that private firms not only want to enter this market under today's conditions but also intend to remain as active participants through all periods of the business cycle. However, the nation's housing finance system is far too complex and dynamic for anyone to forecast with certainty how changes would affect its performance under different economic conditions. Congress should encourage the entry of private firms, but we will have to observe how they perform throughout a business cycle. Since a reliable supply of mortgage funds is so important to homebuyers and many sectors of the American economy, public policy in this area should be made only with great care.

We point out, in particular, that this bill rejects the radical suggestions of some members of the Administration who want to quickly terminate or greatly reduce the Federal Government's role in housing finance.

Third, the bill would amend existing law to help ensure that housing finance is available at reasonable rates for modestly priced homes in all parts of the country. We are pleased that the Committee added two amendments to help many Americans afford decent housing. One of those amendments would authorize Fannie Mae and Freddie Mac to purchase second mortgages that are used to purchase or refinance a home. This would help bring interest costs down to affordable levels for many middle income families. Another amendment would increase the mortgage limits for multifamily projects in high cost areas. The current limits have proven to be unreasonably low in many areas and therefore have prevented many needed rental units from being built.

Fourth, the bill specifically includes certain safeguards to protect the interests of individual investors. The Committee bill would exempt certain mortgage-backed securities from Federal or State securities laws. We reluctantly agreed to these exemptions, because we believe a compelling case was made for amending the laws that relate to mortgage-backed securities. We believe that the Committee has limited these exemptions so that individual investors would not be exposed to undue risks. We will continue to watch this issue carefully, however, and will ask for oversight hearings after the legislation is enacted.

In summary, we believe that the Committee bill has been refined into prudent legislation and deserves broad, bipartisan support. It should be favorably considered by the full Senate at an early date.

DONALD W. RIEGLE, JR.
ALAN CRANSTON.
PAUL S. SARBANES.
CHRISTOPHER J. DODD.
ALAN J. DIXON.
JIM SASSER.
FRANK R. LAUTENBERG.

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